No. [redacted] 44

In the

Supreme Court of the United States

OCTOBER TERM 1964

GERALD SEGAL, Individually and
d/b/a SEGAL COTTEN PRODUCTS, et al.,
Petitioners,

v.

WILLIAM J. ROCHELLE, JR., Trustee,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR THE PETITIONERS

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OPINION BELOW

The opinion of the Court of Appeals (R. 28-36) is reported at 336 F. 2d 298.

JURISDICTION

The judgment of the Court of Appeals was entered on September 9th, 1964 (R. 37-38). The petition was filed on the 7th day of January, 1965, and was granted on the 8th day of March, 1965. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

THE QUESTION PRESENTED

Whether a loss carryback tax item under Title 26,172 of the revised annotated statutes is "property" as defined in §70(a)(5) of the Bankruptcy Act, at the time of the filing of the bankruptcy, but prior to the end of the taxable year.

STATUTE INVOLVED

The statutory provisions involved are §70(a)(5) of the Bankruptcy Act, 11 U.S.C. §110(a)(5). The statutory provisions involved in this case are in pertinent part as follows:

> "(a) The trustee of the estate of a bankrupt * * * shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title * * * to all of the following cases of property wherever located * * * (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise ceased, impounded or sequestered: * * *

STATEMENT

On September 27, 1961 a voluntary bankruptcy petition was filed on behalf of Gerald Segal and Sam Segal, co-partners, trading under the firm name of Segal Cotten Products. On the same day a voluntary bankruptcy was filed on behalf of Sam Segal, individually and Gerald Segal, individually. Subsequently, after the end of the year of 1961, a claim for refund resulting from a loss carryback was made in behalf of the bankrupts. As a result of said claims for refund, the Trustee received the refund checks on the claims.

These funds, by agreement with the attorney for the bankrupts, were deposited in Trustee's bank account to be held in escrow by him pending final determination by the courts of the rights of the parties thereto. The various claims for refund were predicated and based on the entire calendar year 1961 including that year subsequent to the filing of bankruptcy.

The Referee in Bankruptcy entered an order on the 4th day of June, 1963 denying the claims of the bankrupts that they were entitled to the proceeds of the tax refund resulting from loss carryback claims paid by the Director of Internal Revenue. The bankrupts duly and timely filed their petition to review the order of the Referee in Bankruptcy. The Referee in Bankruptcy filed his certification of review, (R. 2-14) including his findings of fact, conclusions of law and opinion. The above mentioned petitions and certificate were considered by the United States District Court for the Northern District of Texas, Dallas Division. The District Court was of the opinion that the referee's order should be in all things affirmed and approved, which it did on August 27, 1963, R. 18-24).

The petitioner gave notice of appeal to the Court of Appeals for the Fifth Circuit and said Court, after due hearing, affirmed the judgment of the lower court, (R. 37-38). Petitioner then filed a motion for rehearing in due time, which was denied on October 12, 1964 (R. 44).

SUMMARY OF THE ARGUMENT

A loss carryback refund is not within the meaning of the word "property" as used in the bankruptcy statute. Courts

of Appeal in the First and Third Circuits have so held in decisions prior to the case at bar. Although the legislative purpose of the Bankruptcy Act is to secure to creditors all property of the bankrupt, an interpretation of the statutory language which attempts to bring a loss carryback refund within its scope will result in unreasonable financial burdens to both the bankrupt and his creditors. The refund involved is based on the taxpayer's experience for a taxable year which was not terminated by an adjudication of bankruptcy. Thus, at the time of bankruptcy no property right to the refund had accrued or was in existence. If the amount of the refund prior to bankruptcy is considered property within the statute, the creditors whose claims accrued subsequent to the adjudication of bankruptcy would certainly be entitled to a proportionate share of the loss carryback refund. The possible time increase in administration by the Trustee of the Bankrupt's estate while waiting for a five year carry-forward refund would seriously frustrate the purpose of the act. Also, there is no statutory authority in existence which would allow the Trustee to utilize the earnings or losses of a discharged bankrupt some four or five years in the future. Such results are clearly a perversion of the statute involved.

ARGUMENT

I.

The loss carryback refund was a mere possibility at the time of Bankruptcy and not entitled to the status of "Property" under the Bankruptcy Act.

II.

The future consequences resulting from a ruling that the loss carryback refund is "Property" as defined in the Bankruptcy Act would frustrate the statutory purpose of the Act.

I.

Prior to the case at bar this particular question relating to the Trustee's rights to a loss carryback refund has twice been considered on appeal and it has twice been found that the Trustee's right is inferior to the Bankrupt's right. The Petitioner's position that the loss carryback refund is not "Property" as defined in the Bankruptcy Act is based upon the reasoning found in the cases of *In Re Sussman*, 289 F. 2d 77 (1961) (3 CA); *Fournier v. Rosenblum*, 318 F. 2d 525 (1963) (1 CA). Such reasoning is founded upon sound legal principles.

The Statute vests title in the Trustee to all non-exempt property belonging to the Bankrupt's estate as of the date of the filing of the Petition initiating the proceeding in bankruptcy. It is the Petitioners' position that such language is exclusive of the loss carryback refund as such refund did not accrue as a right of action until the end of the taxable year which was some three months later. The mere possibility of a refund is not a property right in being, but is an abstraction too remote and uncertain to even be considered a contingent right.

In upsetting the Petitioners' position the lower court found that to approve granting the refund to the Bankrupt

would represent a windfall to which he is not entitled. The reasoning used to avoid this result is more equitable than legal and less persuasive than that used in the decisions of the First and Third Circuits. "This right of action" said the court, "springs from and rests on the fact that the income taxes theretofore paid were paid subject to adjustment in the event of future losses, and are available for that purpose to the end of providing the refund." The court concluded that "the right to adjustment is definite; the time for filing the claim is definite; only the amount of the refund is contingent and this meets the test of a possibility vested with an interest set out in *Williams v. Heard* (1891), 140 U.S. 529".

This reasoning completely disregards the language of the Internal Revenue Code of 1954 which authorizes net operating loss carrybacks (Sec. 172) on the basis of the taxpayer's experience for a taxable year. The taxpayer has no right to a loss carryback refund until the end of the taxable year in which the loss occurs. No right of action accrues at the moment the loss is incurred. This is true even though the claim is enforceable at the end of the taxable year. The principle which supports this provision of the Internal Revenue Code is that losses may be offset by profits and gains during the remaining part of the taxable year which would nullify the right to a refund. Careful analysis reveals that the loss carryback refund situation prior to the end of the taxable year is merely a possibility and *is not vested with an interest* as was the case in *Williams v. Heard,* Supra. The interest which had vested in the *Williams* case accrued when Con-

gress set up a commission to determine distribution of the fund one year *prior* to the Bankruptcy.

In *Fournier v. Rosenblum*, 318 F. 2d 525 (1963) (1 CA), the court construed the Trustee's title to property acquired as of the date of bankruptcy as having the connotation of a specific, definable ownership interest in some respect, whether it be corporeal property or a chose in action. It was decided that a loss carryback refund expectation prior to the end of the taxable year does not possess such a specific, definable ownership interest. The court said 318 F. 2d at page 527:

> "Nor is the prospect that a right of action may arise "Property". For, again as the court pointed out in Sussman (289 F. 2d at Page 78), the concept of "Title" to Property" connotes a definable ownership interest in some res., whether that res be corporeal property or a chose in action. Here, however, there was no res or chose in action in existence on the date of the filing of the petition in bankruptcy. At that time the bankrupt could point to no existing fund and to no existing right in which he had any legal or equitable interest."

The case of *In Re Sussman*, 289 F. 2d 76 (1961) specifically dealt with the question of whether or not the expectation, before the end of the taxable year, of a loss carryback refund is a right of action. It was decided that such an expectation was not a right of action or property as defined in the Bankruptcy Act because at any time prior to the end of the taxable year such an expectation does not conform to the conditions upon which the sovereign has agreed to recognize such a claim. The Court said, 289 F. 2d at page 77:

> "But in this connection it is important to keep in mind that such a right of action for a tax refund is

> created and defined by the statutes in which the United States authorizes a taxpayer to assert such a claim."

In the present situation the statutory basis of a loss carryback claim, as the court below has properly pointed out, is a taxpayer's economic experience for a unit of time, an entire taxable year. This is clear because the net operating loss upon which any claim for a carryback must be based is the excess of allowable deductions over the taxpayer's gross income as computed in a tax return for a taxable year. *Int. Rev. Code §172 (c), 26 USCA §172(c).* Thus, the statutory scheme precludes the existence of any carryback claim until the end of the taxable year.

The principle of law, that the Bankrupt's "possibility" of receiving an asset at the time of filing the Bankruptcy Petition is not an asset of the Bankrupt's estate, is not new to bankruptcy litigants. The following brief abstracts from cases in the federal system give full support to this well established legal principle. In the case of *Harlan v. Archer* (1935), 79 F. 2d 673 (4CA) the Court held that the expectation on the part of the proprietor of a canning factory, that he will be compensated by the government for the destruction of his business through the taking by the government of the land devoted to crops for his factory, is not an asset of his estate. Thus, the trustee in bankruptcy, irrespective of whether the bankrupt's debts were incurred in the operation of the canning factory, is not entitled to the refund from the government. The case of *In Re Prince* (1942), 43 F. Supp. 592 stands for the principle

that a bankrupt's commissions as testamentary trustee, which have not yet been allowed and are not yet payable, are not a part of the bankrupt estate, which the other testamentary trustees may be compelled to turn over to the trustee in bankruptcy. The court in *In Re McManaman* (1943), 50 F. Supp. 869 ruled that where the bankrupt could not retire from his employer's retirement system or withdraw any money from it without discontinuing his employment, the bankrupt's certificate of membership in the retirement system was not an "asset" of the bankrupt's estate to which the trustee in bankruptcy was entitled. These cases represent situations similar to the question involved in the case at bar. These problems were solved by placing a limitation on the statutory interpretation of "property" as defined in the Bankruptcy Act.

The best possible evidence of the intent of the legislature is the language which it employs in its statutes. Legislative history and rules of statutory construction are helpful only in situations where ambiguity exists. In the case at bar, the obvious and plain meaning of the definition of property and right of action in Sec. 70(a) (5) of the Bankruptcy Act does not include a loss carryback tax refund. Moreover, the limitations placed on the refund's existence in the Internal Revenue Code of 1954 prevent it from becoming a property right until the end of the taxable year.

II.

The lower court in its attempt to thwart the passing of a windfall to the bankrupt has overlooked the affect of its

holding in the future. The present decision has created a principle of law which affects all refunds in the future, including those which could result from losses of a business operated subsequent to the discharge of the bankrupts. The additional losses incurred subsequent to the discharge in bankruptcy would be included in determining the amount of the refund to be distributed to the trustee. A distribution *in toto* to the trustee in bankruptcy would be inequitable and prejudicial to the rights of creditors subsequent to the Discharge in Bankruptcy. The public interest would have to be protected by additional measures at an increased cost to the taxpayer.

Section 172(b) (1) (B) of the Internal Revenue Code provides that a net operating loss can be carried forward for five years as well as backward for three years. In some special instances the loss may be carried forward for as long as ten years. Section 172(B) (1) (D). This would necessitate administration of the bankrupt's estate for an additional period of time and reduce the value of the bankrupt estate to the detriment of the creditors. Such a procedure would be burdensome, cumbersome and expensive. The loss carry-forward feature of Sec. 172(b) (1) (B) of the Internal Revenue Code is an *inseparable* part of the loss carry-back refund item which is in question in the case at bar. This carry-forward feature cannot be dispelled merely because it does not arise under the facts herein. The salient point is that a decision in favor of the trustee in the case at bar would necessarily affect those trustees of bankrupt estates who wish to utilize the carry-forward feature. The insur-

mountable point is that there is no provision in the Bankruptcy Act to allow the Trustee to take advantage of the earnings or losses of the discharged bankrupt some five (5) years in the future for the purpose of utilizing the carry-forward feature which is part and parcel of the question before this Honorable Court. While the Referee and the lower courts in the case at bar have attempted to "avoid the unjust and inequitable result" of granting the bankrupt the benefit of the loss carry-back refund herein, their decision is paramount to granting the trustee power and rights relating to the earnings, income, or losses of a discharged bankrupt for the purpose of utilizing the loss carry-forward feature, which is a flagrant intrusion into the realm of the Legislature. In such a case, the words "unjust and inequitable result" would certainly apply with like force to the trustee's position. The possible consequences of the decision in the lower courts herein as opposed to the decision in the *Sussman* case and the *Fournier* case are frightening, from a legal or equitable standpoint. There is, simply, no statutory authority which does allow the Trustee to utilize the earnings or losses of a discharged bankrupt some four or five years in the future.

Petitioner submits that the language of Sec. 70(a)(5) of the Bankruptcy Act should be strictly adhered to. If this well settled and fundamental interpretation requires, as contended by respondent, alteration on the grounds of policy such as injustice to creditors of the bankrupt, relief is not with the courts, but with the legislature. Resort to legislation has been the solution in other similar situations, such

as death of a taxpayer or dissolution of a corporation. If the referee's desired result is to be accomplished, it should not be effectuated by the courts; but through a legislative change to remedy a statutory limitation upon which the taxpayer has justly relied.

CONCLUSION

For the reasons stated it is respectfully submitted that the judgment of the Court below should be reversed.

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HENRY KLEPAK,

Counsel for Petitioners.

August 23, 1965

CERTIFICATE OF SERVICE

I hereby certify that I have delivered to Honorable William J. Rochelle, Jr., Attorney for Respondent, whose office is in Dallas, Texas, a copy of this Brief received by him this ..... day of August, 1965.

Respectfully submitted,

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HENRY KLEPAK